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Tax Features

Foundation Leads International Tax Delegation to Europe

Meet with U.S. Treaty Partners to Discuss Impact of U.S. Policies

At presstime senior staff of the Tax Foundation are heading a delegation from the U.S. to the UK, Belgium, France and Germany for a series of international tax conferences and briefings on the impact of U.S. tax policy on U.S. treaty partners. The delegation includes members of the staffs of the House Ways and Means Committee and the Senate Finance Committee who are meeting with foreign treasury officials and tax policy makers in London, Brussels, Paris and Bonn.

Among our treaty partners' representatives will be UK Inland Revenue officials Richard Pratt, Head of European Community and International Trade Issues; Peter Fawecett, International Division - Policies; and Ian N. Hunter, International Division - Technical. In Brussels, Willy de Clercq, Chairman of the External Relations Committee in the European Parliament, is a featured speaker, and a meeting is being held with Christiane Scrivener, Commissionaire for Taxation in the European Commission.

The challenge facing fiscal authorities around the world today is daunting: how to fashion and administer a tax policy that takes into account not only traditional domestic concepts of equitable taxation, but those of other nations as well. Since tax treaties are the fundamental tool available for moving toward consensus on tax treatment of multinational corporations, the Foundation is promoting mutual understanding among fiscal authorities by hosting this series of conferences.

The events are part of the Foundation's international tax assessment project. This ongoing program of studies, reports, and conferences is designed to inform tax policy makers and business leaders on international taxation. Specifically, the focus is on the consequences of tax provisions affecting the foreign affiliates of U.S.-based companies and the U.S. affiliates of foreign-based companies.

FRONT BURNER

Spending Restraint Gets Short Straw in New House Rule

Wayne Gable
President,
Tax Foundation

As federal tax policy has more and more become an exercise in revenue raising, professional revenue estimators have found themselves blinking in an unaccustomed spotlight. On January 3, the first day of the new Congress, that spotlight intensified. The House of Representatives passed an unfortunate rule declaring the Congressional Budget Office (CBO) to be the official revenue estimating agency, or "scorekeeper," for pay-as-you-go spending legislation instead of the Office of Management and Budget (OMB).

My general feeling is that estimators on both ends of Pennsylvania Avenue do a professional job. They are more concerned with econometric modeling and microsimulation than with politics. But there is no doubt that the assignment of official estimating responsibility to OMB in the budget negotiation was an important concession to the President's desire to hold down congressional spending. When it comes to pay-as-you-go, "OMB is more concerned about the paying than the going," as Rep. Silvio Conte (R-MA) said during the floor debate.

What is pay-as-you-go, and why is the House of Representatives so dead set against having OMB do the scorekeeping? As part of last year's Omnibus Budget Reconciliation Act of 1990 (OBRA), any bill which will cut taxes or increase entitlement spending must be accompanied by a provision which, according to an official estimate supplied by OMB, "pays" for the decreased tax or increased entitlement, either by cutting a different entitlement or by raising revenue elsewhere. Ways and Means Committee Chairman Dan Rostenkowski (D-IL) claims the new rule will

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Tax Foundation

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Washington's Largest Monument: The National Debt

It is certainly not a happy new year for government finance in America. A whopping $3.33 trillion national debt, nearly quadruple its 1980 level, represents a $13,298 debt for every man, woman, and child in the U.S.

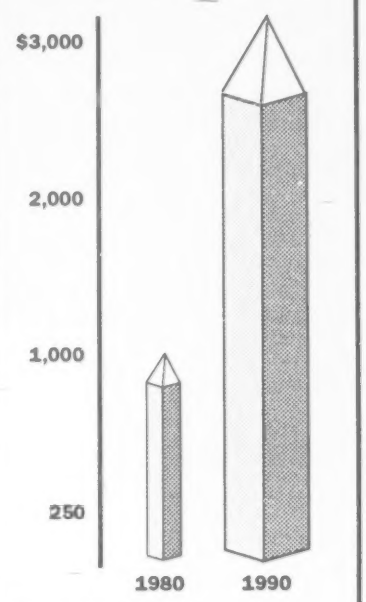
Anticipating higher indebtedness in the coming year, the federal government has raised its 1991 debt ceiling to a record $4.14 trillion. Even this $810 billion increase in the legal limit may not be adequate as we quickly approach this ceiling. The culprit is faster government spending, especially higher interest payments, the growing cost of the savings and loan bailout, the estimated $30 billion cost of Operation Desert Shield and $50 billion in lost federal revenue due to the recession.

The Statutory Debt Limit

The debt limit, or debt ceiling, is an amount written into law as a legal limit to the federal government's indebtedness. It was revised an average of 2.3 times per year in the eighties, four times in 1987 alone for a total of $500 billion, the largest annual increase of the eighties. Of the decade's 21 increases, ten were quick solutions, after the federal government had surpassed its spending authority.

Growth of the National Debt in the 1980s

($Billions)



Source: Tax Foundation

The Deficit and the Debt

The trend of our national debt from 1940 to 1980 showed a increase of nearly $21.5 billion a year, a troublesome rate of increase to budget officials at the time. But in the last decade, the debt has skyrocketed. In 1980 it stood at just over $900 billion, but by 1985 it had doubled to over $1.8 trillion. Far from slackening in the second half of the decade, the debt grew to $2.8 trillion over the next four years.

Interest Cost of the Debt

Interest payments on our debt continue to climb steadily as our annual deficits pile up. Payment of interest on the debt is currently the third largest federal government expenditure, following income security and defense. For fiscal year 1991, the estimated annual interest on the public debt is $259 billion, $29 million for every hour of the day, or $495,580 dollars per minute.

The net interest (interest paid out minus interest received) has even risen as a percentage of total outlays, despite rising total outlays. From 1955 to 1975, the percentage hovered around 7.3 percent. During the eighties, it shot up from 8.9 percent to 14.8 percent of outlays. See table below for detail.

Trends in Federal Debt, Deficits, and Related Measures

Selected Fiscal Years 1940-1989

($Billions Except Per Capita)

	Debt Outstanding (a)			Net Interest				Deficit	
Year	Total	Per Capita	% of GNP	Total	Per Capita	% of Outlays	% of GNP	Total	% of GNP
1940	$ 50.7	$ 381	52.9%	$ .9	$ 7	9.5%	.9%	- $2.9	- 3.0%
1945	260.1	1,859	122.5	3.9	28	3.4	1.5	- 47.6	- 22.4
1950	256.9	1,687	96.3	4.8	32	11.3	1.8	- 3.1	- 1.2
1955	274.4	1,654	71.0	4.9	30	7.1	1.3	- 3.0	- 0.8
1960	290.5	1,608	57.3	6.9	38	7.5	1.4	-	-
1965	322.3	1,659	47.9	8.6	44	7.3	1.3	- 1.4	- 0.2
1970	380.9	1,858	38.5	14.4	70	7.4	1.5	- 2.8	- 0.3
1975	541.9	2,509	35.6	23.2	107	7.0	1.5	- 53.2	- 3.5
1980	908.5	3,989	34.0	52.5	231	8.9	2.0	- 73.8	- 2.8
1981	994.3	4,320	33.3	68.7	299	10.1	2.3	- 78.8	- 2.6
1982	1,136.8	4,889	36.2	85.0	366	11.4	2.7	- 127.9	- 4.1
1983	1,371.2	5,840	41.3	89.8	382	11.1	2.7	- 207.8	- 6.3
1984	1,564.1	6,600	42.4	111.1	469	13.0	3.0	- 185.3	- 5.0
1985	1,827.5	7,638	46.2	129.4	541	13.7	3.3	- 212.3	- 5.4
1986	2,129.5	8,776	50.9	136.0	560	13.7	3.3	- 221.2	- 5.3
1987	2,354.3	9,609	53.1	138.6	566	13.8	3.1	- 149.7	- 3.4
1988	2,614.6	10,567	54.6	151.7	613	14.3	3.2	- 155.1	- 3.2
1989	2,881.1	11,528	55.9	169.1	677	14.8	3.3	- 151.9	- 2.9
1990	3,330.7	13,298	61.6	183.8	734	14.7	3.4	- 220.4	- 4.1

(a) End of fiscal year.

Sources: Treasury Department; Office of Management and Budget; House Budget Committee; and Tax Foundation computations.

1990: A Brief Review of the Year in Tax Policy

After an agonizing exercise in budget summitry, the federal government closed 1990 with a $220.4 billion deficit, this despite FY90 revenues topping $1.03 trillion, a 4.1 percent increase from FY89. The growing deficit prompted Congress and the Bush Administration to pass the Omnibus Budget Reconciliation Act of 1990 (OBRA), allegedly the grandest attempt at deficit reduction in history. In fact, disputes over the budget deficit overshadowed every significant piece of tax legislation during 1990.

The year began with two major budget issues at the top of the agenda: the placement of the Social Security trust funds off budget and a reduction of the capital gains tax rate. Senator Moynihan (D-NY) proposed that the Social Security tax be reduced to equal the level of outgoing benefits, a "pay-as-you-go" system. This change was intended principally to accomplish two tasks: reduce taxes for the income class hardest hit by payroll "contributions"; and to prevent Social Security "surpluses" from hiding the true size of the budget deficit. Although the Social Security trust funds are currently off budget, Moynihan's proposal to cut the rate was unsuccessful.

"Disputes over the budget deficit overshadowed every significant piece of tax legislation during 1990."

The Bush Administration's most notable initiative in 1990 was its push for a cut in the capital gains tax rate. While the Joint Committee on Taxation predicted the lower rate would drain $11.4 billion from anticipated federal revenue, the Treasury Department insisted that the proposal would raise $12.5 billion in new revenue. The entire debate did not occur at this professional level, however. Many legislators used the issue to campaign against "the rich" who they alleged to be the only beneficiaries of a preferential rate on capital gains.

Unable to come to any agreements, the President and congressional leaders convened a budget summit. With President Bush abandoning his promise of "No New Taxes," both parties agreed to increased tax revenues, yet neither Bush nor congressional leaders wished to take credit for bringing specific new taxes to the negotiating table. As the summit continued and Congress left for summer recess, lawmakers backed themselves against a wall with a mounting deficit, a government shutdown, and numerous continuing resolutions.

Due to Congress' inability to pass a budget by the end of the fiscal year, the government was forced to shut down for three days. Congress did succeed, however, in dodging the $150 billion sequester required by the Gramm-Rudman-Hollings Act. During negotiations, Congress increased the statutory debt limit six times, with the debt finally reaching $3.3 trillion. (See article on page 3.)

The President signed OBRA into law on October 27, and as in previous budget summits, the compromise which emerged instituted higher taxes and promised spending cuts to reduce the deficit. The Act's proponents promise it will trim the deficit by $496 billion over five years. Its $164.6 billion in revenue raising provisions are estimated to cost an average of $664.68 per capita in new taxes over the next five years. The provisions of the new budget which raise the most new revenue include:

- a new 31 percent top marginal rate;
- increase in the individual alternative minimum tax rate to 24 percent;
- raising the Medicare wage cap from $51,300 to $125,000;
- phase-out of personal exemptions for taxpayers with adjusted gross incomes above $100,000 (single taxpayer), $125,000 (head of household), and $150,000 (married, joint return);
- new 10 percent tax on luxury items;
- additional five cents per gallon motor fuel tax;
- permanent extension of the telephone excise tax;
- increase in the tobacco tax, an additional 8 cents by 1993;
- increased taxes on beer, wine, and distilled spirits.

During their budget negotiations, however, lawmakers left out of their calculations two expenditures that will cost taxpayers billions of dollars in years to come: Operation Desert Shield, and the escalating costs of the savings and loan bailout. Add to these the estimated $50 billion in lost revenue due to the current recession, and the estimated fiscal 1991 budget deficit rises to well over $400 billion.

State-Level Finance

Following federal trends, total state tax revenues increased as numerous states raised tax rates. In 1990, state revenues jumped nearly $20 billion, a 7.5 percent increase from the previous year's take. More than 31 states raised taxes, mostly sales taxes covering gasoline and cigarettes.

Well before the economic downturn was felt at the national level, several states found themselves in dire financial straits. In particular, California, Massachusetts, New Jersey, New York, and Virginia faced huge budget deficits. Most states cannot rely on deficit spending in a budget crunch because their constitutions require a balanced budget, leaving them only the politically difficult options of cutting spending or raising taxes.

California

Facing a $2.7 billion fiscal 1990 budget deficit, California lawmakers considered tax increases of more than $1.1 billion on sales, alcohol, and personal and corporate income. Governor Deukmejian opposed any tax increases and wanted the fiscal shortfall to be met by cutting the state budget. Faced with 17 initiatives on the November ballot, California voters turned down the five major tax initiatives. They included legislation to make it more difficult for state and local governments to raise taxes, an increase in the general sales tax from 4.75 percent to 5.25 percent, and an increase on the excises of alcoholic beverages. The only major initiative voters approved was Proposition 140, which imposes a two-term limit on state senators and a three-term limit on state assembly members.

Massachusetts

Massachusetts began the year facing a projected budget deficit of $1 billion. Governor Dukakis appointed a

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task force to address the problem, but lawmakers and business leaders abandoned the plan for economic summits to cut the deficit. The state legislature finally approved a tax increase bill that it had been considering since 1989 in order to balance the state budget.

The bill hit taxpayers with an increase in personal income tax from 5 percent to 5.75 percent in 1990. Massachusetts' taxpayers face a further retroactive increase in 1990 to 5.95 percent and 6.25 percent in 1991. In 1992, the tax will revert to the 1990 level of 5.95 percent. In addition to the personal income tax hike, the tax increase included extending the 5 percent sales tax to professional services (i.e. lawyers, accountants), increasing the capital gains tax from 10 to 12 percent, and increasing the motor fuels tax from 11 to 17 cents.

Massachusetts closed fiscal year 1990 with a sharp decline in tax collections of 3.3 percent, with precipitous drops in sales and corporate income receipts. Personal income collections rose a modest 4.2 percent.

New Jersey

Outgoing Governor Thomas Kean began 1990 by imposing a state spending and hiring freezing due to a possible fiscal shortfall of $590 million at the request of Governor-elect James Florio. Governor Florio, beginning his term, continued the freeze and proposed a tax hike package of $1.4 billion to counter the state's fiscal deficit. The package, passed by both houses, increased the sales tax from 6 to 7 percent, effective July 1, 1990, increased the excise tax on cigarettes and alcohol, effective July 1, 1990, and doubled the top personal income tax rate to 7 percent, effective January 1, 1990.

"Governor Florio's tax hike package of $1.4 billion . . . increased the sales tax and doubled the top personal income tax rate to 7%."

New York

New York began the year by initiating the final phase of the state's major income tax cut. Governor Mario Cuomo, however, turned the tables by postponing the tax cut in the budget bill due to the state's difficult financial condition, facing a $700 million shortfall. Instead of becoming effective in October 1990, the .5 percent reduction of the top rate will be phased in over a three-year period. The top personal income tax rate will remain 7.875 percent for 1990. Also, the new budget delayed an increase of the standard deduction, imposed a three-year corporate income surcharge on tax liability, and raised the cigarette tax rate from 33 to 39 cents. New York City has contributed significantly to the $700 million deficit with its own projected deficit of $400 million.

Virginia

Governor Douglas Wilder began his term by ruling out tax increases. Faced with a projected $1.94 billion shortfall, he announced a plan to cut from the current services budget $333 million in state aid to local governments and 3 to 5 percent in state agency spending, and to impose a salary freeze on state workers. Wilder has cut his own salary by 2 percent to persuade judges to take a similar step and eliminated a 2 percent salary increase for college faculty. Virginia used a carrot and stick approach with tax evaders, declaring a two-month tax amnesty, which raised more than $32 million, but at the same time increasing the penalties for tax evasion.

International

Canada

Canada faced a fiscal deficit of CD$30.5 billion in 1990. Finance Minister Michael Wilson presented a new Canadian Budget that planned to reduce the budget deficit by freezing spending on government programs for two years and capping other programs for five years instead of raising taxes.

The Canadian government, however, decided to reduce the deficit in part by passing a bill that replaces the current Manufacturers' Sales Tax (MST) with a Goods and Services Tax (GST). The current 13.5 percent MST was levied on a select group of items before the item reached the customer. The new 7 percent GST is a multistage value added tax which covers all goods and services, except basic foods, medical and dental care, drugs, rents, financial services, tuition, and farm goods and services. The GST is estimated to raise revenues of CD$5.5 billion to CD$24 billion. Canadians, who fear that the government will raise the GST rates in the future, were outraged and demanded wage hikes to offset the tax. The tax is effective January 1, 1991.

The Canadian government has granted more than CD$2.5 billion in research and development incentives to Canadian corporations under the 1985 Scientific Research and Experimental Development Tax Incentive Program. The program entitles corporations performing R&D 20-35 percent tax credits for qualifying expenditures.

United Kingdom

The nation's budget surplus has shrunk from BP2.2 billion to BP400 million as a result of smaller tax and privatization revenues, and higher government spending. This shrinking budget surplus and increased inflation have delayed income tax cuts and increased tension about the new poll tax. The poll tax, effective April 1, 1990 for England and Wales, replaced property taxes and levies a community charge on residents based on the per capita cost of their local governments. It is designed to fund local services, replacing the local traditional property-based rating system. A nationwide debate over the fairness of this measure has included mass demonstrations against the ruling Conservative party and contributed to the lack of confidence in Prime Minister Margaret Thatcher before she stepped down.

The UK's government also imposed a new tax system regarding commercial property taxes that will hit retail companies especially hard, with some suffering a nearly eightfold increase over last year's assessment. The government, however, is providing a five year transition period which limits the increases to 20 percent a year in real terms. An increase in property taxes resulted from a government revaluation of commercial property.

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Peter Barnes, Deputy International Tax Counsel, U.S. Department of the Treasury

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B. Anthony Billings, Tax Foundation Senior Research Fellow; Associate Professor of Accounting, Wayne State University

John F. Brussel, Tax Director - International, AT&T

Session #2: Tax Treatment of Foreign Investment in the U.S.

Panel Chairman: Robert Ashby, Assistant Vice President, Taxes, Northern Telecom Inc.

Congressman Philip M. Crane (R-IL), House Ways and Means Committee: Trade, Ranking Minority Member

Elliot L. Richardson, Senior Partner, Milbank, Tweed, Hadley & McCloy

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Foreign Investment in U.S. Will Thrive If Reason Conquers Emotion

by Congressman Philip M. Crane (R-IL)

Let's put the debate over foreign investment in its historical context. Americans take a lot of understandable pride in the initiative and hard work put in by their forefathers during the nation's infancy and up through the better part of the 19th century. This period witnessed the most spectacular industrial growth the world had ever seen, and throughout those years, the nation that financed our growth was our mortal enemy — Great Britain.

So despite the current brouhaha over foreigners investing in the U.S., foreign investment has contributed to the great wealth of this nation in the past despite much more adverse circumstances. Indeed, if it were not a good thing, why would so many Americans be foreign investors? As I hear emotional pleas for protectionism, I wonder why the authors of those pleas never condemned Americans investing overseas. It was just last year that foreign investment coming into this country exceeded what we were investing abroad.

In fact, much of the debate on this question is really Japan-bashing. Those who don't have logic and facts to support their positions are resorting to this emotional appeal because many Americans still remember December 7, 1941. British investment here is about $119 billion; Japan's — $69 billion. Japan just went ahead of the Netherlands for the first time last year. Where is the condemnation of the British and the Dutch?

I submit that we are living in an increasingly international economy and are bound to countries all over the world. Ironically, many of the same people who argue against foreign investment in the U.S. are in the vanguard of urging investment from this country in the Soviet Union. The whole free market world is making investments over there to help them make the transition to membership in the civilized world. I think that is sound policy.

I have suggested to Japanese executives that they use their extraordinary marketing skills to promote the Japanese people and culture. They have the ability to do it and must recognize that in the ad hominem debate that protectionists are trying to fashion on this question, Japan is the easiest target.

One Japanese CEO has reminded me that after the war, America insisted upon thousands of their people coming to the U.S. to study our economy so that Japan could become a major industrial power in the shortest possible time. When studying the structure of the tax code at the University of Chicago under Milton Friedman, Friedrich A. Hayek, and George Stigler, all Nobel Prize winners, they learned to write a tax code that rewards saving and investment. As a result, Japan didn't tax interest, dividends or capital gains for all practical purposes. He then asked,

"Those who don't have facts to support their positions are resorting to this emotional appeal because many Americans still remember December 7, 1941."

"Why do you punish your people for saving and investing?" To which the only appropriate answer is, "Because we're jerks, that's why!" We sit back and marvel that as a percentage of personal income, they are saving 20-22 percent annually while the U.S. is at the bottom of the world's industrial nations.

The last thing the U.S. should do is engage in scapegoating, especially singling out one country over another the way we are doing at now, implying that there is some evil conspiracy behind it.

Instead, we should be looking inward to resolve any apprehensions we may feel about foreign investment in this country. There are ways we could reward people for saving and investing in this country. I hope that is the direction the Ways and Means Committee takes when it looks at the question of foreign investment.

Ed. Note: This column was excerpted from Rep. Crane's speech to the Foundation's international investment seminar. The opinions expressed are not those of the Tax Foundation. Editorial replies are encouraged.

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enforce the "pay-as-you-go" system with timely estimates for all provisions. But Budget Committee Chairman Leon Panetta (D-CA) went more to the heart of the matter when he said, "Members did not want to negotiate with OMB." The implication is clearly that Members' input on estimates will be more welcome with CBO.

"When it comes to pay-as-you-go, 'OMB is more concerned about the paying than the going,' as Rep. Silvio Conte (R-MA) said during the floor debate."

"[Professional estimators] are more concerned with econometric modeling and microsimulation than with politics. But there is no doubt that the assignment of official estimating responsibility to OMB in the budget negotiation was an important concession to the President's desire to hold down congressional spending."

In fact, OMB's designation as the official scorekeeper was one of the only points the White House gained in last year's budget negotiation, and one of the only spending restraints in the package. The White House looked forward to being able to artfully position its scorekeeping to keep Congress under control and to advance its own agenda. For example, if the White House had wanted to reignite its capital gains objective, it could have done so because their budget estimates show substantially higher revenues from this source in the years ahead.

I have long been a skeptic of budget summitry in general, and even before the new House rule passed, I felt that OBRA would be no exception: new taxes vigorously and immediately enforced while spending restraints die aborning. And so the demise of this spending restraint on the first day of the new Congress is not surprising, but it is discouraging and cannot help but lessen every realistic observer's hope that OBRA will achieve substantial deficit reduction.

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